Supreme Court, U.S.
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No. 00-259

In the Supreme Court of the United States

WAYNE I. ELLIOTT, ET AL., PETITIONERS

v.

COMMODITY FUTURES TRADING COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE COMMODITY FUTURES TRADING COMMISSION IN OPPOSITION

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QUESTION PRESENTED

Whether the court of appeals gave undue deference to the Commodity Futures Trading Commission's determination that trades of wheat futures by petitioners were of such risk and so symmetrical in price and duration that they supported the conclusion that the trades were the product of prearrangement, in violation of the Commodity Exchange Act and Commission regulations.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1b-40b) is reported at 202 F.3d 926. The opinion and order of the Commodity Futures Trading Commission (Pet. App. 1c-29c) is unofficially reported at [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,243.

JURISDICTION

The judgment of the court of appeals was entered on February 3, 2000. A petition for rehearing was denied on May 11, 2000. The petition for a writ of certiorari was filed on August 9, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

This case arises from an opinion and order of the Commodity Futures Trading Commission (Commission) finding petitioners liable for multiple violations of the Commodity Exchange Act (Act), 7 U.S.C. 1 *et seq.*, and Commission regulations in connection with noncompetitive futures trading on the Chicago Board of Trade (CBOT). Petitioners are high-volume traders in wheat futures contracts on the CBOT.

1. A wheat futures contract is an agreement to sell the agreed-upon amount at a certain price on a certain date in the future. Wheat contracts ordinarily are delivered in the months of March, May, July, and September. Trading wheat futures during the delivery months is riskier because of uncertainties associated with whether the wheat can be delivered in the contracted-for amount at the agreed-to price. The CBOT operates contract delivery on a "first-in, first-out" basis: the oldest contracts are placed at the front of the delivery line; the newer contracts at the back. "Traders can reposition themselves in the delivery line (a practice called 'freshening') by liquidating old open positions in the nearby delivery month and buying equivalent volume contracts for future delivery (called the deferred month)." Pet. App. 3b. The purpose of freshening is to delay the date by which the physical commodity (*i.e.*, wheat) will be delivered if a futures contract is not liquidated. Because the new long position has been established later in time, the trader defers the assignment of delivery by moving to the back of the delivery line. Some traders will try to profit from changes in the spread between cash and futures prices by holding long futures in the current delivery month and short futures in a deferred month. To profit,

the trader must hold his open position in the current month for as long as possible while avoiding delivery. The transactions involved in freshening, like all trades, expose the trader to some risk from price fluctuations. Pet. App. 3b-4b.

2. In 1994, the Commission's Division of Enforcement brought a complaint on behalf of the Commission against petitioners, four floor traders in the CBOT wheat pit. The complaint charged petitioners with engaging in wash sales in violation of 7 U.S.C. 6c(a)(A), executing noncompetitive trades in violation of 17 C.F.R. 1.38(a), and causing non-*bona fide* prices to be reported in violation of 7 U.S.C. 6c(a)(B). The complaint described misconduct in connection with 32 spread trades in wheat futures contracts on eight trading days during and immediately preceding the delivery cycle for the March 1991 wheat contract. The complaint alleged that in each of the charged transactions, petitioners traded exclusively among themselves in freshening their positions through prearrangement by buying and selling March-May or March-July wheat spreads among themselves in equal quantities at the same price differential, without incurring a loss, realizing a profit, or changing their net positions.

In December 1995, an administrative law judge (ALJ) of the Commission conducted a four-day hearing. The case presented by the Division of Enforcement relied principally on trading records indicative of prearrangement and on CBOT trading data. To explain those records, the Division also presented testimony by an expert witness, Hugh Rooney, whose factual account of the trading was uncontested by petitioners. Pet. App. 5c-7c. Petitioners presented testimony that the challenged trades were undertaken for the legitimate market purpose of freshening and that each of the

trades was independent, open, and competitive.[1] Specifically, they maintained that they traded exclusively among themselves because they were among the few active spread traders in trading large volume. They testified that access to CBOT-published delivery information enabled them to estimate one another's open positions and to anticipate the volume necessary to freshen their positions. *Id.* at 20c. After the hearing, the ALJ issued an initial decision in which he credited petitioners' testimony, criticized the Division's failure to present direct evidence of prearrangement, discounted without analysis the body of circumstantial evidence offered by the Division, and found that the evidence adduced by the Division was insufficient to sustain the charges. *Id.* at 9d-19d. The Division appealed the ALJ's decision to the Commission.

3. The Commission addressed whether the ALJ had properly credited petitioners' testimony as outweighing the Division's body of circumstantial evidence. The Commission made clear that, although freshening serves a legitimate market purpose when accomplished through open and competitive trading, a lawful economic purpose does not legitimize otherwise prohibited trading techniques. Pet. App. 14c-15c, 24c.

Petitioners' case relied principally on their testimony that their trades were competitively executed, that the precise configuration of their trading was the product of experience, intelligent observation, and publicly available trading data, and, moreover, that they traded exclusively among themselves because there were no other traders in the wheat pit interested in trading

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[1] Petitioners offered the testimony of other traders that the challenged trades appeared to have been made by open outcry. Pet. App. 9c.

large volume. Pet. App. 23c. That testimony had formed the basis for the ALJ's conclusion that pre-arrangement had not occurred.

The Commission conducted an independent review and concluded that petitioners' explanations were not borne out by the record. It was undisputed that the trade data on which petitioners purportedly relied were not available early in the freshening period, when fully half of the charged trades occurred. Furthermore, although there were relatively few traders in the wheat pit on the final two trading days at issue, there were as many as 41 traders in the pit early in the delivery cycle, when more than half of the charged trades occurred. Pet. App. 18c-23c. Because those facts contradicted the ALJ's credibility findings, the Commission concluded that deference to the ALJ's credibility assessment was unwarranted and thus reviewed de novo the inferences to be drawn from the record. *Id.* at 23c.[2]

Consistent with its precedent, the Commission recognized that the difficulty of establishing illegal trading through direct evidence means that circumstantial evidence, particularly inferences drawn from trading data and patterns, must often be used to prove trade

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[2] With respect to the testimony of other traders that the trades were "cried out," the Commission observed that the formality of open outcry in the pit does not compel the conclusion that the trades were competitive, and cited prior decisions in which it observed that traders who have prearranged their trades are often in an excellent position to create a false appearance of *bona fide* trading. Thus, "evidence consistent with the appearance of lawful market activity does not necessarily negate an otherwise valid inference that traders were knowing participants in wash sales." Pet. App. 17c (quoting *In re Bear Stearns & Co.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,994, at 37,663 (1991).

practice violations. Accordingly, the Commission began its own analysis of the record evidence with the common characteristics of the challenged trades: in each of the trade sequences, petitioners in combination were able to sell and repurchase a large volume of wheat spreads in equal quantities at the same price differential, without suffering a loss, realizing a profit, or changing their net positions. The Commission concluded that "[t]he interrelationship of these trades, illustrated by precise and symmetrical configurations, the exclusivity of trading among the four [petitioners], and the absence of profit or loss incurred, compels the conclusion that the trades were prearranged by [petitioners]." Pet. App. 23c. The Commission observed that the symmetry and precision of the challenged trades, which were characteristics not normally found in competitively executive transactions, stood in marked contrast to the characteristics of at least one petitioner's freshening trades that did not involve the other petitioners. *Id.* at 14c-16c.

The Commission further noted the enormous risks involved for petitioners in trading "such large positions": "once the trade is made, it cannot be undone. If a single [petitioner] in the ring-like transaction failed to play his part, none of the [petitioners] would succeed. In these circumstances, it is unlikely that a trader would repeatedly act against his own economic interest without advance knowledge that the other participating [petitioners] would continue trading the spread, enabling him to offset his newly-acquired long position." Pet. App. 16c. The Commission noted that a pattern of interrelated trading characterized by "uniform conduct of the participants is a critical element of noncompetitive trading." *Ibid.* The Commission also found significant that petitioners' actions in many of the

challenged trades were inconsistent with their own interests but consistent with the interest of the group. *Id.* at 15c-17c, 20c-22c. Based on those conclusions, the Commission reversed the ALJ's decision, found petitioners liable on all counts of the complaint, and imposed sanctions. *Id.* at 24c-26c.

4. The court of appeals affirmed. The court recognized that the issue before it was "not whether the CFTC here might have applied a different analysis and reached a different result; the issue is whether the analysis the agency did apply and the result it did reach have a rational basis and are supported by substantial evidence." Pet. App. 20b. The court found "good reason" for the Commission's rejection of the ALJ's credibility findings, observing that

> [t]he ALJ identified two crucial factors purportedly supporting his finding of no pre-arrangement: first, the traders said they acted on publicly available information, and, second, they said that they had no choice but to trade among themselves because no one else was interested in participating. The CFTC found that the evidence contradicted both of these factors.

Id. at 25b.

The court explicitly rejected petitioners' primary argument that circumstantial evidence was insufficient to establish liability. "The Division of Enforcement * * * need present only circumstantial evidence—and only a preponderance of it—to establish liability for trade practice violations. Like most trade practice enforcement actions, this case involves a set of undisputed facts and the competing inferences that can be drawn from those facts." Pet. App. 1b (citations omitted). The court observed that courts have applied

a deferential standard of review to Commission determinations of the evidence necessary to prove violations, and it concluded that "[d]eciding whether a particular set of circumstances supports an inference of non-competitive trading on the futures markets is an issue peculiarly within the Commission's area of expertise." *Id.* at 14b (citing *Ryan* v. *CFTC*, 145 F.3d 910, 916 (7th Cir. 1998)).[3] The court concluded that the Commission had "carefully considered all of the evidence, articulating its reasons for discounting some and accepting some." Pet. App. 15b. Accordingly, the court deferred to the Commission's "considered, supported and reasonable decision." *Ibid.*

Judge Easterbrook dissented. Pet. App. 27b-40b. He criticized the court for deferring to the Commission's liability analysis, dismissing the "expertise" of the individual Commissioners because none was trained in statistical analysis or game theory or had experience in industrial organizations or as a financial economist. *Id.* at 29b-30b. The dissent criticized the Commission's decision for ignoring *Stoller* v. *CFTC*, 834 F.2d 262 (2d Cir. 1987), a case that was not cited in the petitioners' main brief to the Commission, Pet. App. 28b. And the dissent criticized the panel majority for relying on the opinion testimony of the Division's expert, *id.* at 29b-31b, and for rejecting the ALJ's credibility deter-

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[3] The two circuits that decide the overwhelming majority of significant commodity trade practice cases, the Second and Seventh Circuits, consistently have applied a deferential standard to Commission determinations of the evidence necessary to prove violations of various sections of the Commodity Exchange Act and Commission regulations. See, *e.g.*, *Reddy* v. *CFTC*, 191 F.3d 109, 117 (2d Cir. 1999); *Monieson* v. *CFTC*, 996 F.2d 852, 859-862 (7th Cir. 1993); *Gimbel* v. *CFTC*, 872 F.2d 196 (7th Cir. 1989); *Silverman* v. *CFTC*, 549 F.2d 28, 29-33 (7th Cir. 1977).

mination absent the "usual grounds" of "incompatibility between oral and documentary evidence," *id.* at 31b. The dissent further expressed the view that freshening serves "multiple good purposes" and that prearrangement in the context of freshening hurts no one. *Id.* at 37b.

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is not warranted.

1. Petitioners claim that the decision below conflicts with this Court's decision in *Allentown Mack Sales & Service, Inc.* v. *NLRB*, 522 U.S. 359, 376-78 (1998), regarding the proper deference to be accorded an administrative agency's factual findings. That assertion is incorrect. *Allentown Mack Sales* focused on the impropriety of an agency's application of a standard of proof different from the standard it has formally announced. See *id.* at 368, 376. Petitioners have not asserted in this case that the Commission purported to apply one standard of proof while in fact applying a different one. The Commission's decision here did not represent a shift in policy.

Prearrangement is a form of noncompetitive trading that violates 17 C.F.R. 1.38. Pursuant to 7 U.S.C. 9, the Commission assesses the weight of the evidence to determine whether a violation has occurred. The Commission's decision in this case is consistent with its jurisprudence with respect to both the elements of a *bona fide* transaction and the standard of proof required to establish a trade practice violation. See, *e.g.*, *In re Buckwalter*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,995 (1991); *In re Bear Stearns*

& Co. [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,994 (1991); *In re Gilchrist*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,993 (1991); *In re Rousso* [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,133 (1997); *Reddy* v. *CFTC*, 191 F.3d 109, 118-120 (2d Cir. 1999).

This Court consistently has required that the reviewing court find, based on the whole record, the quantum of evidence that could satisfy a reasonable factfinder. *INS* v. *Elias-Zacarias*, 502 U.S. 478, 481 (1992); *American Textile Mfrs. Inst.* v. *Donovan*, 452 U.S. 490, 522 (1981); *Universal Camera Corp.* v. *NLRB*, 340 U.S. 474, 487-488 (1951); *NLRB* v. *Columbian Enameling & Stamping Co.*, 306 U.S. 292, 299-300 (1939). Consistent with that precedent, the court below recognized that the focus of its review was not on whether the Commission might have applied a different analysis and reached a different result, but rather "whether the analysis the agency did apply and the result it did reach have a rational basis and are supported by substantial evidence." Pet. App. 20b (citing 5 U.S.C. 706). That is precisely the standard of review prescribed by this Court. As the Court explained in *Allentown Mack Sales*, the substantial evidence test requires merely the degree of evidence that could satisfy a reasonable factfinder, not that which satisfies the court that the requisite fact exists. 522 U.S. at 366-367; see also *Universal Camera*, 340 U.S. at 488. Thus, a court of appeals may reverse an agency's decision under the substantial-evidence test only if it concludes that the evidence in the record compels a contrary conclusion. *Elias-Zacarias*, 502 U.S. at 481 n.1.

The court of appeals sustained the Commission's findings in this case only after considering the record evidence as a whole, including contradictory evidence

and evidence from which conflicting inferences could be drawn, and identifying specific record evidence and reasons that justified the Commission's choices. The court's approach is well-illustrated by its treatment of the expert testimony. As the court properly concluded, both the ALJ and the Commission drew a distinction between the expert's factual testimony, which was undisputed, and his opinion testimony. The Commission discounted the latter and "simply drew its own inferences from the undisputed accounts of the trades * * *. The patterns, not [the expert's] opinion, swayed the Commission." Pet. App. 18b.

There is no inconsistency between the court's decision to discredit the expert's opinions but not his undisputed factual testimony and its affirmance of the Commission's factual findings. See *Sierra Club* v. *Marita*, 46 F.3d 606, 622 (7th Cir. 1995) (to apply the admissibility standards of *Daubert* v. *Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993), to an agency's choice of methodology would be "intrusive, undeferential, and not required"). The court properly left the choice of fact-finding method to the Commission, subject to the requirement that, whatever method it used, the Commission's findings must pass muster under the applicable standard of review. Pet. App. 22b.[4]

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[4] Accordingly, the Commission properly relied on its own institutional knowledge in carrying out its adjudicative function. See *Reddy*, 191 F.3d at 117-119 (affirming inference by CFTC of illegal trade practices from pattern and other circumstantial evidence, without use of formal statistical methods); *Kraft, Inc.* v. *FTC*, 970 F.2d 311, 318-319 (7th Cir. 1992) (FTC can use its own judgment to interpret meaning of advertisements without conducting formal studies of consumer perceptions, even though

The court of appeals' application of the appropriate standard of review is similarly demonstrated by its treatment of the Commission's decision to reject petitioners' testimony that they had not engaged in prearrangement even though the ALJ had credited their explanations:

> Our dissenting colleague also wonders how the CFTC could overturn the ALJ's credibility determination without a good reason. * * * But there was a good reason. The ALJ identified two crucial factors purportedly supporting his finding of no prearrangement: first, the traders said they acted on publicly available information, and, second, they said that they had no choice but to trade among themselves because no one else was interested in participating. The CFTC found that the evidence contradicted both of these factors. The publications on which the traders supposedly relied, the "CBOT Deliveries Last Trade Date Assigned Reports" and the "Issue and Stop Listing," were "unavailable on at least some of the trading days at issue and on other relevant days contained only partial data." And on some of the charged days early in the delivery cycle, a substantial number of traders did participate.

Pet. App. 25b (citation omitted). The court of appeals thus deferred to the Commission only after finding that the Commission had identified objectively reasonable bases for rejecting the testimony credited by the ALJ.

Petitioners and the dissent below have not reconciled the ALJ's conclusions with those facts. Instead, they

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few FTC commissioners have personal experience in advertising), cert. denied, 507 U.S. 909 (1993).

simply assert, incorrectly, that the Commission gave no reason for its rejection of the ALJ's conclusions and ignore the distinction (made by the Commission and recognized by the court of appeals) that the material issues in this case turned primarily on evidentiary inferences rather than determinations concerning the credibility of witnesses. *Id.* at 25b, 23c.[5] In fact, the reason given by the Commission is precisely the reason endorsed by the dissent for upsetting a credibility determination: petitioners' testimony was incompatible with undisputed documentary evidence in the record. *Id.* at 31b.[6]

Because the court of appeals reviewed the evidence supporting the Commission's decision in light of the

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[5] The dissent characterized the Commission's explanation for rejecting the ALJ's findings as resting on a "ludicrous" distinction between "truthful" and "credible" testimony. Pet. App. 31b. The Commission's opinion makes clear, however, that it relied on a distinction, made repeatedly by the court of appeals, between determinations of personal credibility based on demeanor and broader evaluations of the validity of the substance of a witness's testimony. *Id.* at 23c.

[6] Petitioners suggest that the Commission is not entitled to the deference normally accorded to an administrative agency within its area of authority because the individual Commissioners had neither personally traded futures on an exchange floor nor been trained in such academic fields as statistics or economic theory. Pet. 13-14, 20. Neither petitioners nor the dissent below identify any authority for the proposition that judicial review of agency decisions varies depending on the backgrounds of individual commissioners. As the panel recognized, the "expertise" of administrative agencies is institutional. Pet. App. 20b-21b. See 1 Kenneth C. Davis & Richard J. Pierce, Jr., *Administrative Law Treatise* § 8.6, at 395-396 (3d ed. 1994) ("The role of a typical agency's staff is much greater than the role of the staff of a trial court. * * * The decision tends to be an amalgam of the views of the agency heads and the staff.").

entire record, taking into account contradictory evidence and competing inferences, it properly performed its function of ensuring that the Commission's decision was supported by substantial evidence. Accordingly, "the possibility of drawing two inconsistent conclusions from the evidence does not prevent an administrative agency's finding from being supported by substantial evidence." *American Textile Mfrs. Inst.*, 452 U.S. at 523 (quoting *Consolo* v. *FMC*, 383 U.S. 607, 620 (1966)). Thus, petitioners' criticisms of the court's decision amount to little more than a disagreement with its review of the evidence. Petitioners identify no misstatement of law that necessitates this Court's review.

2. Contrary to petitioners' assertion, the court of appeals' decision does not conflict with *Stoller* v. *CFTC*, 834 F.2d 262 (2d Cir. 1987). In *Stoller*, the Second Circuit addressed whether the Commission had properly concluded that a trader violated the anti-wash-sale rule after a summary disposition without a fact-finding process to resolve disputes over material facts. *Id.* at 264-267. *Stoller* held that because the Commission had not given members of the industry adequate notice that the conduct at issue violated the Act, it could not be enforced against the trader in question. *Id.* at 264, 267. *Stoller* makes clear that trades to freshen a contract are not intrinsically objectionable, but it does not foreclose the Commission from finding such trades to be violations of federal law if they employ otherwise unlawful trading methods, as the Commission found in this case.

Here, both the Commission and the court of appeals accepted the premise that any finding of a violation of 7 U.S.C. 6c(a) in the circumstances of this case would rest on proof of prearrangement. Pet. App. 15b, 15c-22c. The disputed issue on appeal was simply whether the

Commission's factual finding that prearrangement had occurred was supported by substantial evidence. In affirming the Commission's liability finding, the court thus did not create any conflict with *Stoller*. It merely found that the legal requirements of *Stoller* were satisfied by the facts in this record. As the court observed,

> [*Stoller*] explained that the historical definition of "wash sales" concerned "transactions that were virtually risk-free, often prearranged, and intentionally designed to mislead." In the present case, the Commission is sanctioning these traders after finding as a fact after hearing that their conduct fits this historical definition * * * There is no conflict with *Stoller*.

Id. at 26b (citation omitted). While this case and *Stoller* both involve freshening trades, there is no conflict between the Second Circuit's reversal of the Commission's decision in *Stoller* on notice grounds and the Seventh Circuit's affirmance of the Commission's factual finding of prearrangement here.

Finally, the court of appeals' decision does not create legal uncertainty. Nothing in the court's decision or in the Commission's opinion casts doubt on the legality of freshening, so long as it is done by lawful means. The illegality of prearrangement was well established prior to this case, and the Commission's decision here, which was affirmed by the court of appeals, rests on a finding of prearrangement. Petitioners are not insulated from liability for that illegal trading practice on the ground that their motive was to freshen their futures contracts.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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